ISLA Response to the European Commission's Targeted Consultation on improving the EU's Macroprudential Framework for the Banking Sector

International Securities Lending Association (ISLA)

islaemea.org

Background

The International Securities Lending Association (ISLA) welcomes the opportunity to respond to this consultation on behalf of our membership of over 170 firms, including institutional investors, asset managers, custodial banks, prime brokers, and service providers. ISLA represents the common interests of securities lending and financing market participants across Europe, the Middle East and Africa. More information on ISLA and its members can be found **here.**

A link to the consultation can be found **here.**

Question 15

15. Is the EU macroprudential toolkit adequate for monitoring and mitigating banks' systemic risks related to global market-based finance, securities and derivatives trading as well as exposures to other financial institutions?
(1 = not at all adequate, 5 = fully adequate)
1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 15 in light of the experience gathered so far, identifying in particular gaps related to derivatives, margin debt and securities financing transactions.

The International Securities Lending Association (ISLA) welcomes the opportunity to respond to this consultation on behalf of our membership.

The Association strongly believes that the current EU macroprudential toolkit in place, implemented through the Capital Requirements Regulation and Directive, are sufficiently adequate for mitigating banks' systemic risks, including systemic risk associated to banks' exposures to the non-banking sector, through the use of securities financing transactions (SFTs).

ISLA does not support the view of the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) that a broadening of the macroprudential toolkit is warranted for all types of SFTs. ISLA does support the efforts of the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) to transform historic 'shadow banking' into resilient market-based financing, including through the introduction of a framework for minimum haircuts. ISLA would advise however, that this framework needs to be reviewed to provide more clarity on which SFT types it may impact, as it is the view of ISLA that securities lending and borrowing, as one type of SFT that is not primarily used for financing, but rather for sourcing securities, is not an investment tool that creates a build-up of leverage, which the Commission states as a reason behind a proposal for the expansion of a macroprudential framework to SFTs.

Implementing the BCBS policy as it stands could consequently affect the functioning of securities lending and borrowing transactions with a negative effect on the market. It is important to note that securities lending is a low risk, discretionary activity for beneficial owners and any fundamental changes to the current market structure may result in pushing lenders away from the market, therefore reducing market liquidity.

The vast majority of securities are borrowed through large custodian agent lenders, where non-cash collateral is usually held by a tri-party collateral manager on behalf of the underlying principals. Accordingly, the related securities collateral is not generally rehypothecated, thus the lender will not be able to create leverage.

ISLA would argue that the Securities Financing Transaction Regulation (SFTR), the final phase of which entered into force in 2021, provides regulators with sufficient transparency to demonstrate the build-up of securities financing positions. Although ISLA understands that SFTR did not implement the FSB recommendations on margining and haircuts, SFTR does obligate borrowers to SFTs to provide their consent to the re-use of the collateral they post. Refusal to give such consent, depending on market participants' discretion, has the potential to limit, to a certain extent, the build-up of system-wide leverage. ISLA support the daily reporting of collateral reuse and agree that it is paramount to assess financial stability risks as described by the FSB.

The examination of a sufficient macroprudential toolkit cannot be performed until there is a comprehensive assessment with sufficient data granularity on the contribution of SFTs to the build-up of leverage. ISLA believe that the necessary data is being collected under SFTR, however the final phase only entered into force in 2021, which ISLA believe is not a significant amount of time to collect the required data to be able to effectively assess whether SFTs contribute to systemic risk.

Additionally, ISLA supports numerical haircut floors as an instrument to tackle the build-up of leverage from SFTs however, there are several practical issues that would require clarification before they can be implemented. As ISLA has previously highlighted in consultation responses to the BCBS, the use of haircut floors in the context of securities lending transactions must be clarified. Currently, haircuts apply to the collateral provided in exchange for the securities borrowed, i.e., to non-cash collateral or to cash collateral in non-base currency. However, the FSB specifically targets "securities-against-cash" transactions, which implies that numerical haircut floors may need to apply to the securities on loan against cash, rather than the collateral. Imposing the haircut floors in this way could again create a disincentive for beneficial owners to make their securities available for lending, and potentially have a detrimental impact on the liquidity of some securities and on settlement.

Haircuts are currently used by market participants as a risk management tool however, ISLA believe that regulatory floors may change this perception and stifle liquidity. It also introduces a complexity in the context of wide portfolio-based trading, such as agency lending and the calculation methodology used for netting SFTs.

In a 2019 ESRB report on EU Non-bank Financial Intermediation Risk, the ESRB states that *'to gain a more comprehensive view of interlinkages in the financial system, supervisors need to be able to link data covering activities in certain market segments, such as derivatives or SFTs to the balance sheet data of the institutions engaging in these markets.'*

ISLA would support the assessment of macroprudential measures that can be used for SFTs in the upcoming SFTR legislative review, scheduled for 2022. However, as it stands, if the European Commission were to implement the FSB standards created by the BCBS for minimum haircut floors on SFTs, securities lending (the loan of securities) would not fall under the current scope and only reverse stock loans, which are more likely to be entered into for financing purposes.

ISLA would welcome the opportunity to discuss any of the concerns outlined in the above with EU legislative bodies in more detail.